

Economic Policy #1

The Concept of Economic Policy

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- Approaches to economic policy
- Objectives of economic policy
- The whys and hows of public intervention
- Evaluation of economic policy

Three approaches #1

- *Positive economics*:
 - studying the effects of economy policy (EP) choices on the economy => EP is regarded as *exogenous*
 - determining transmission channels (e.g. impact of an interest rate cut)
- *Normative economics*:
 - making recommendations to the Prince
 - based on positive-economics results and on the Prince's utility function
 - political and social constraints (*second* best problem)
 - information constraints (asymmetric information, communication failures)

Three approaches #2

- *Political economics*
 - Agents ' behaviour is *endogenous*
 - Government is a machine directed by rational players with specific objectives and facing specific constraints
 - EP is determined by *policy regime*

The main tasks of policymakers

- set and enforce the rules of the economic game
- tax and spend
- issue and manage the currency
- produce goods and services
- fix problems (or pretend to)
- negotiate with other countries

A general framework of EP making



Role of institutions

Douglass North (1993): *“Institutions are the humanly devised constraints that structure human interaction. They are made up of formal constraints (rules, laws, constitutions), informal constraints (norms of behavior, conventions, and self imposed codes of conduct), and their enforcement characteristics.”*

Institutional framework affects directly market equilibriums and effectiveness of EP instruments.

Objectives of EP (examples)

- Humphrey-Hawkins Act (USA):

“promote full employment and production, increased real income, balanced growth, a balanced Federal budget, adequate productivity growth, proper attention to national priorities, achievement of an improved trade balance..”

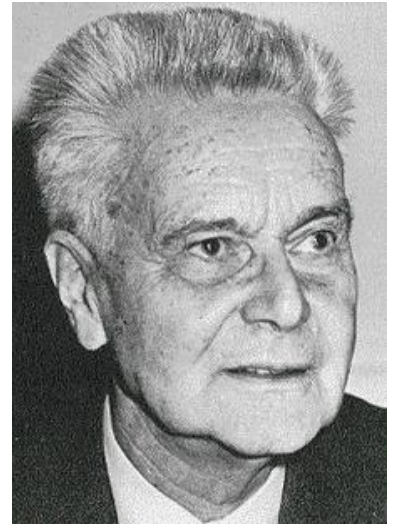
- Article 3 of the treaty on the EU:

“work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement the quality of the environment.”

=> Objectives of EP are numerous and sometimes contradictory.

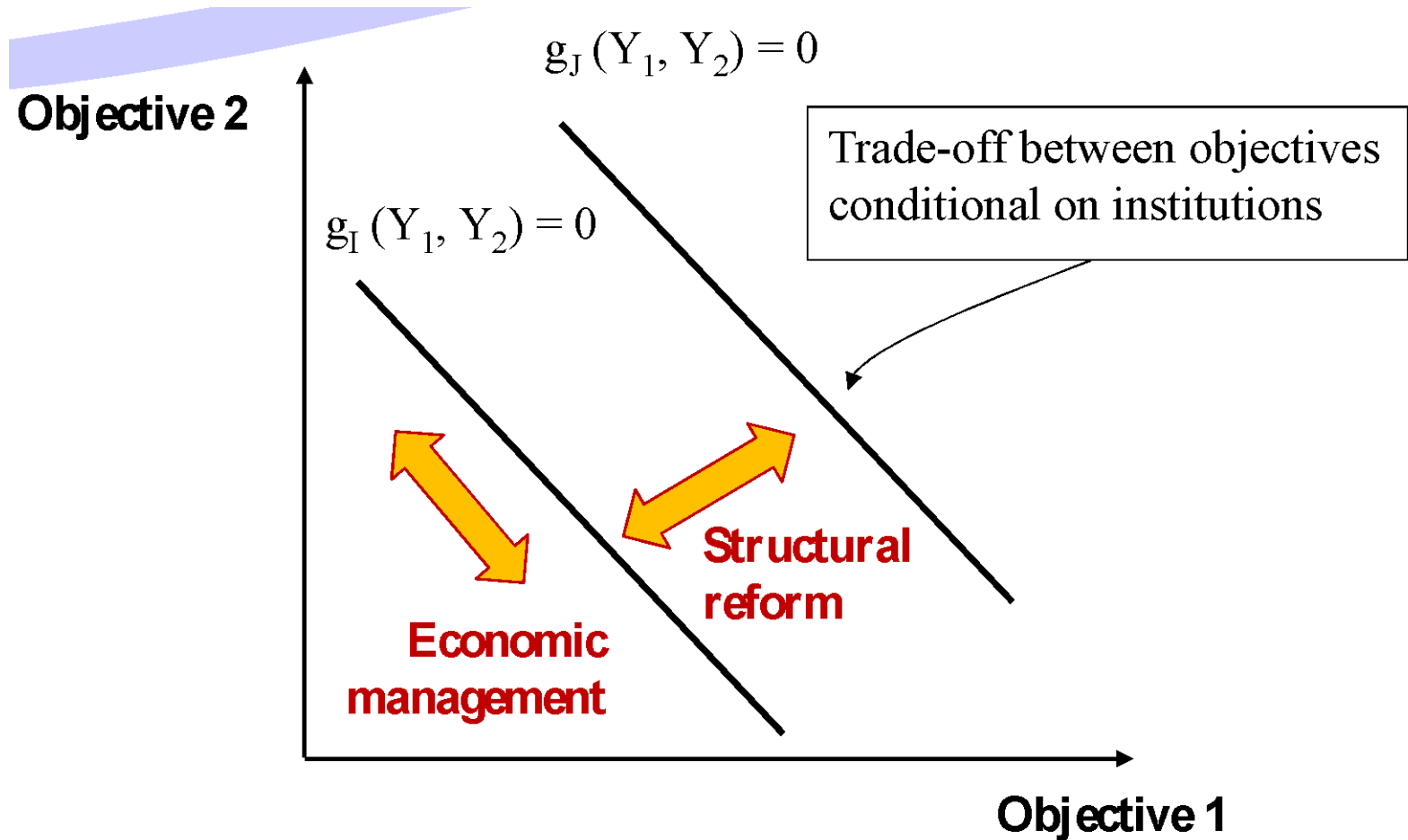
EP as a succession of trade-offs

- *Tinbergen rule*: to reach an independent objectives governments needs at least an equal number of EP instruments.



- In reality, number of instruments < number of objectives
=> there are inevitable ***trade-offs***

Economic management vs. structural reform #1



Economic management vs. structural reform #2

- *Economic management* contains various levers such as tax rates, interest rates and public spending.
- *Structural reforms* aim to modify EP trade-offs by changing the institutions (CB independence, choosing a currency regime, adopting framework for budgetary policy etc.)

The employment-productivity trade-off

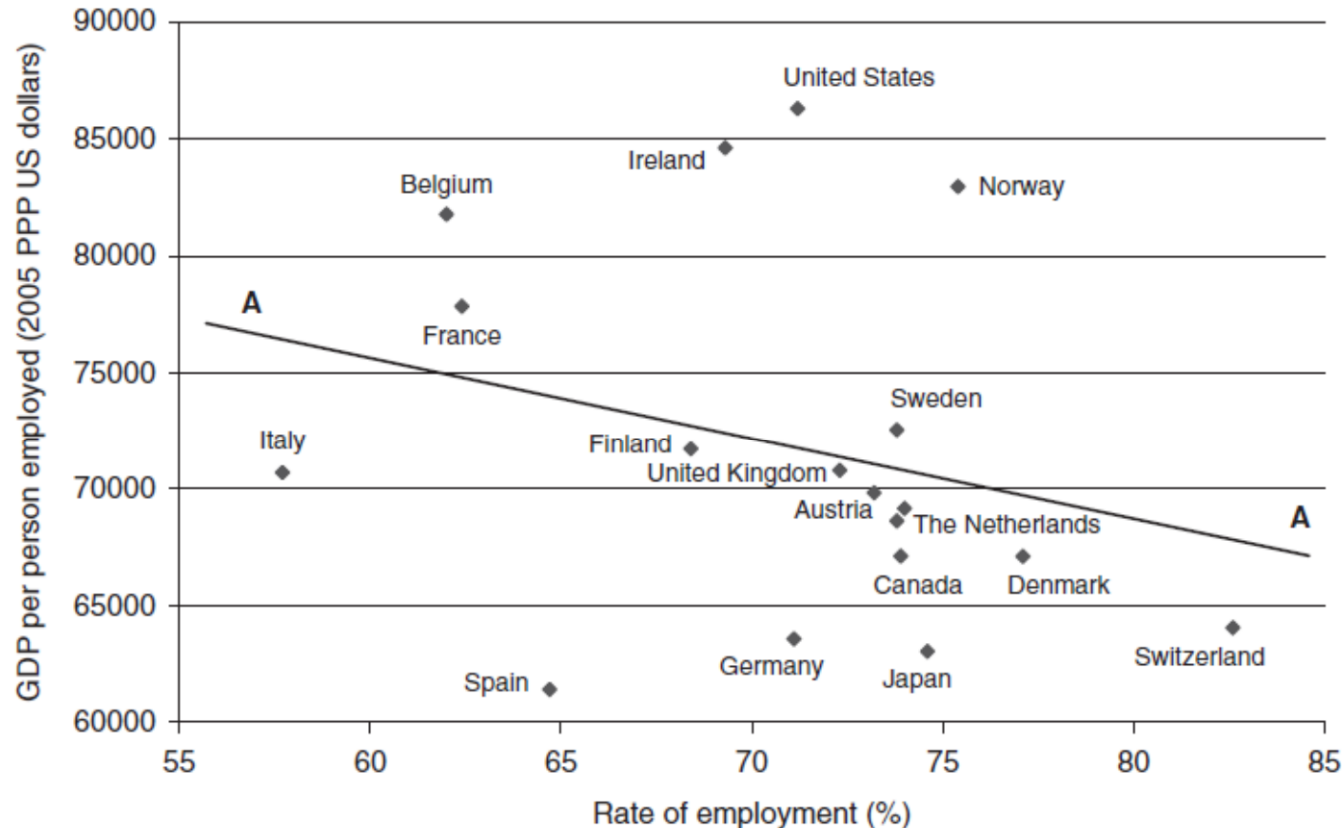
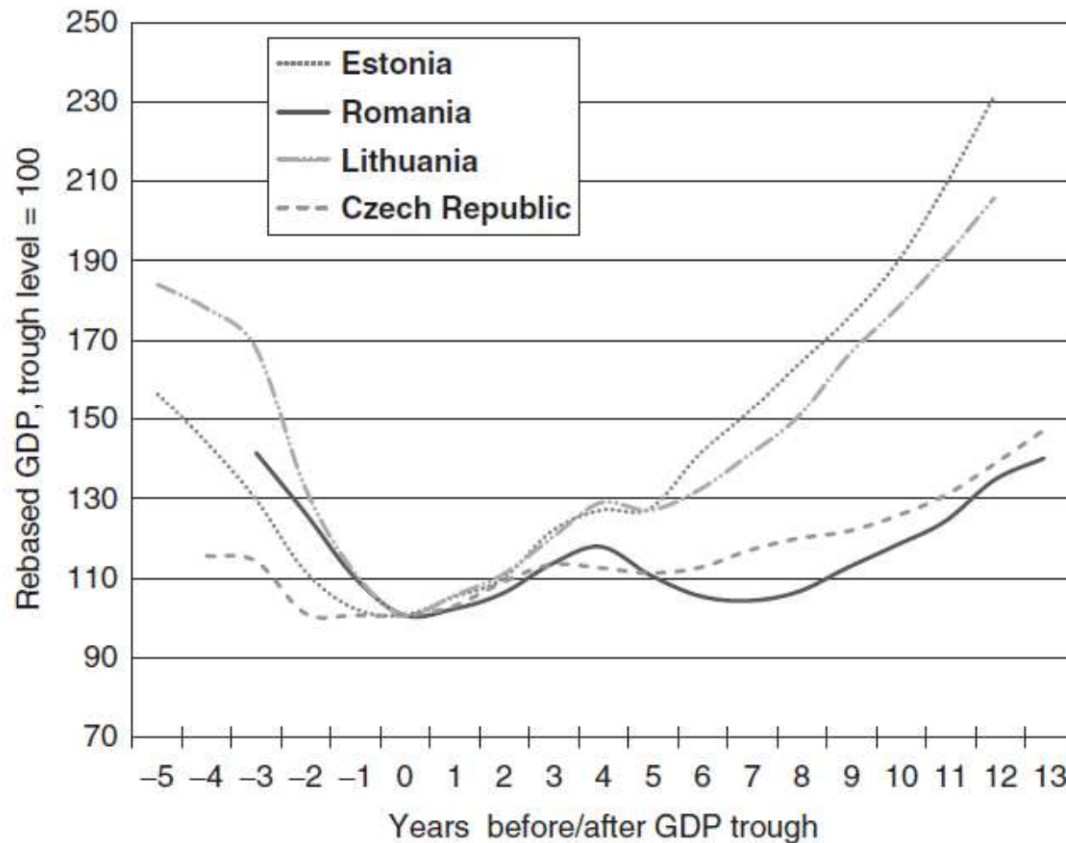


Figure 1.2 The employment–productivity trade-off in 2005.

Source: Authors' calculations using Groningen Growth and Development Center and OECD data.

Structural reforms in post-communist countries



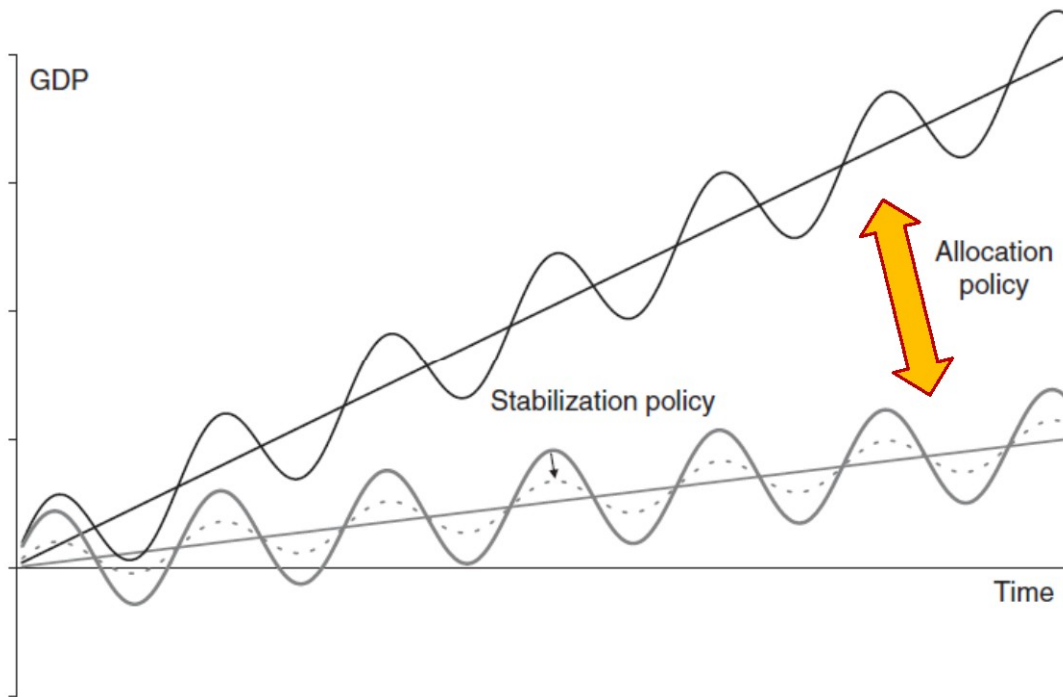
Structural reforms often have negative short-term, but positive long-term effects.

The Whys and Hows of Public Intervention

Three functions of economic policy (Musgrave&Musgrave, 1989):

- **Allocation** \Leftrightarrow market inefficiency (ex. competition, education, climate)
- **Macroeconomic stabilization** \Leftrightarrow nominal rigidities (ex. monetary and fiscal policies)
- **Income redistribution** \Leftrightarrow corrects the primary distribution of income (eg. taxation, social transfers, housing)

Stabilization vs. allocation policies



=> Allocation policies impact potential output

=> Stabilization policies impact the output gap

Collateral effects

Direct and indirect effects of three public policies (direct effects are indicated in bold type)

	Allocation	Stabilization	Redistribution
Reduction in income tax	+ (increase in labor supply)	+ (increase in demand for goods)	– (increase in inequalities)
Increase in government expenditures	+ / – (depends on the content of expenditure and on the possibility of crowding out private expenditure)	+ (by hypothesis)	+ / – (depends on the content of expenditure)
Increase in social transfers	– (risk of inactivity trap)	+ (increase in the demand for goods)	+ (reduction in inequalities)

Note: The initial situation is supposed to be characterized by Keynesian unemployment.

More on allocation

- ***Imperfect competition***: fight market power, regulate innovation rents and natural monopolies
 - Instruments: antitrust, intellectual property, regulation etc.
- ***Externalities***
 - Instruments: regulation, taxes or markets (Coase theorem)
- ***Imperfect information***: innovation rents, consumer illiteracy, moral hazard, conflicts of interest
 - Instruments: mandatory disclosure, financial regulation, etc.
- ***Incomplete markets***
 - Instruments: public education, credit enhancement

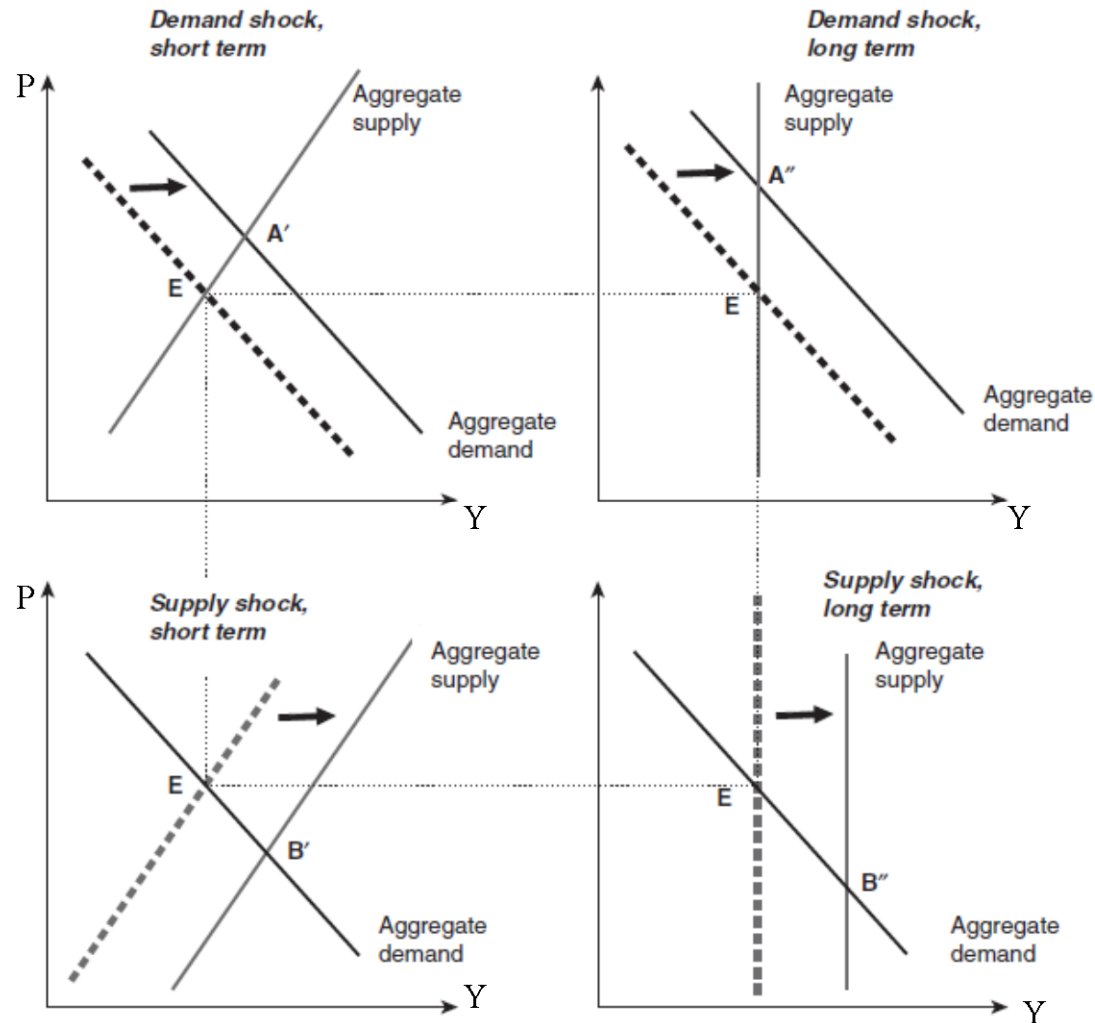
More on stabilization #1

J. M. Keynes (1883-1946):

private instability (*'animal spirit'*) + ineffective self-correcting mechanisms (nominal rigidities)

=> need for *counter-cyclical policies* to smooth out economic fluctuations and prevent economic depressions.

More on stabilization #2



More on redistribution #1

- Two arguments:
 - Pareto optimality (resulting from first welfare theorem) does not amount to social justice
 - Efficiency-enhancing policies (e.g. trade) make winners and losers
- Income distribution can be corrected in a non-distortionary way through lump-sum transfers

More on redistribution #2

- Difficult to implement in practice => frequent *equity-efficiency trade-offs*
- Need for *social-welfare criteria*:
 - To compare gains and losses / Pareto optimum
 - To help address trade-offs
 - To act consistently

Evaluating EP: decision criteria

Single criterion for efficiency, stabilization and equity is conceivable in theory.

In practice EP choices are generally represented as implying trade-offs between different dimensions.

Ex-post policy evaluation

- *Controlled experiments*
 - Individuals subject to a policy shock are compared with a pilot group
- *Natural experiments*
 - Econometric technique developed to address heterogeneity and selection bias (*difference in differences method*)

GDP as a proxy of welfare #1

- widely used in practice
- misleading because overlooks leisure, depletion of natural resources, externalities
- need to promote alternative measures

GDP as a proxy of welfare #2

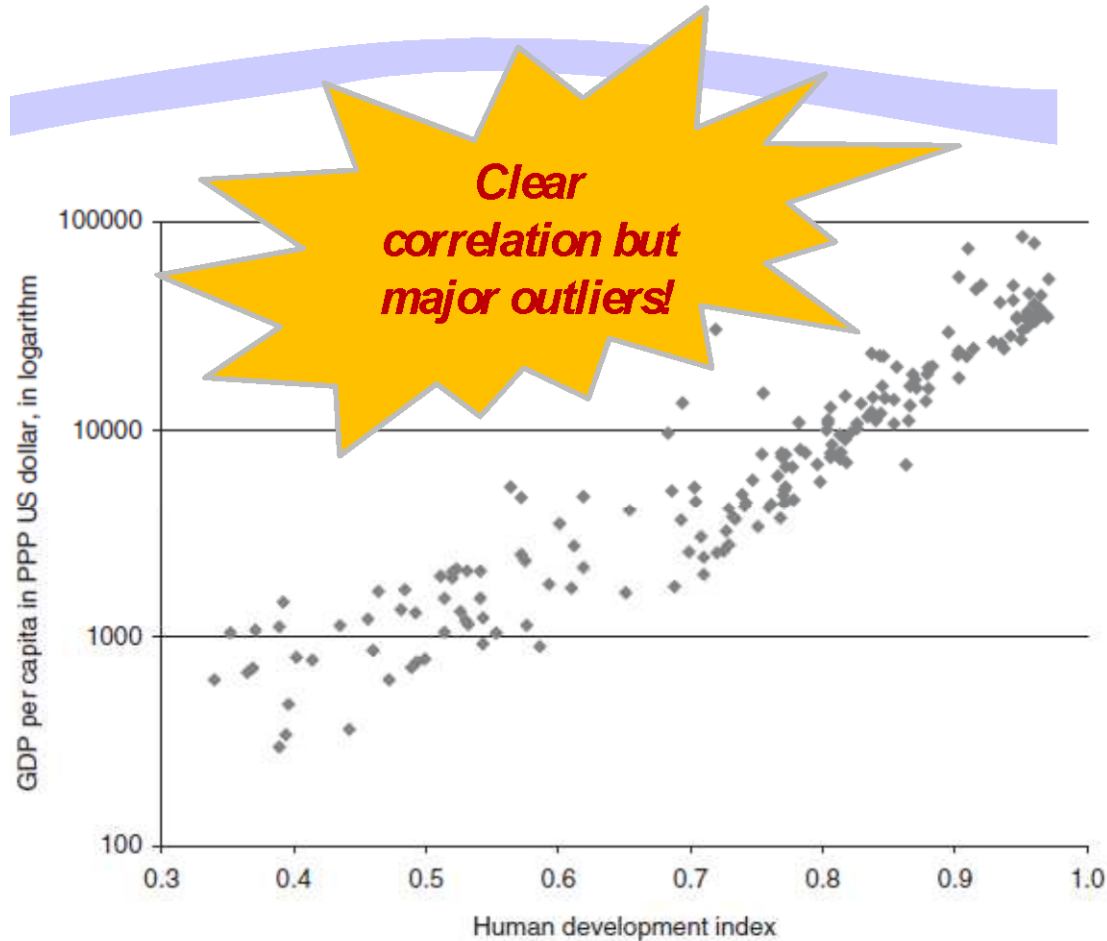


Figure B1.9.1 GDP per capita and human development index in 182 countries, 2007.

Source: UNDP, Human Development Report 2009.